SEPTEMBER 9, 1985 THREE DOLLARS

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Forbes

CREDIT CARD SCAMS

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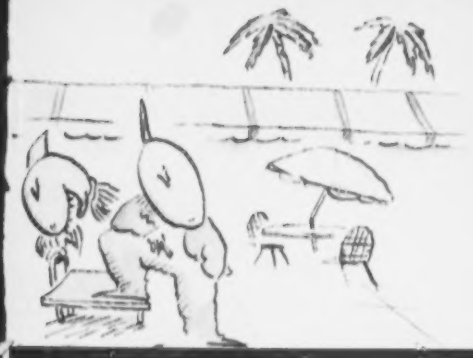

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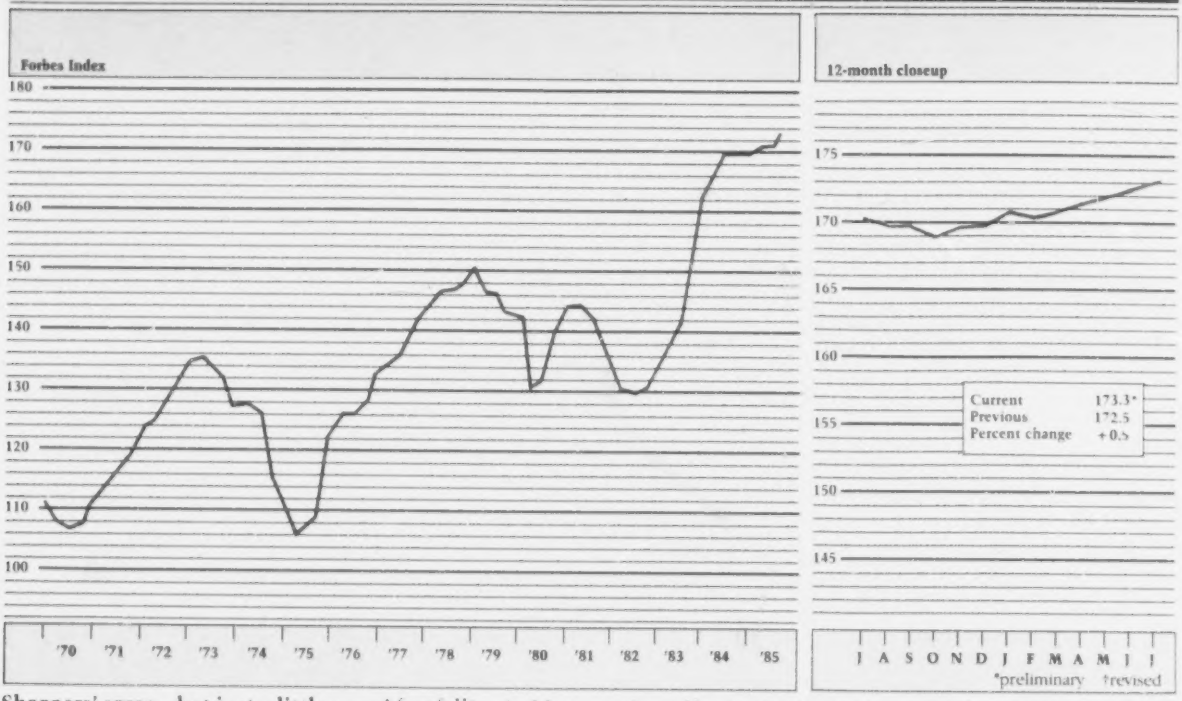
Cover illustration by Wayne McLoughlin

The Forbes Index



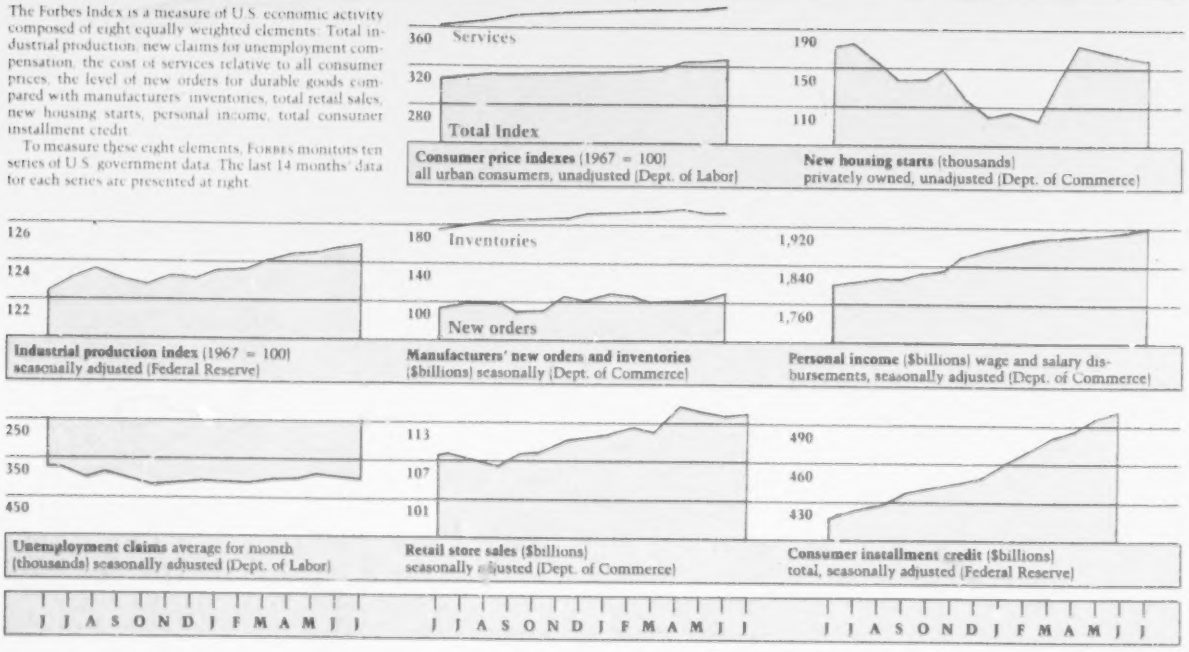
Shoppers' spree—but just a little one. After falling in May and June, retail sales rebounded in July, rising 0.4%. Consumer installment credit, meanwhile, is up 1.4% for the newly reported June period. This figure, however, represents the weakest monthly increase since November. Despite lower mortgage rates, new housing starts continued to fall in July for the third consecutive month, off 1.7%.

Overall, the Forbes Index posted a 0.5% month-to-month gain. Since the start of the year, only one other time, in April, has the Index increased this much. While industrial production is up slightly and unemployment claims showed a tiny decrease, it is the strength of manufacturers' new orders, up a solid 3.6% in June, that has had the greatest influence in elevating the Index.

The Forbes Index Components

The Forbes Index is a measure of U.S. economic activity composed of eight equally weighted elements: Total industrial production, new claims for unemployment compensation, the cost of services relative to all consumer prices, the level of new orders for durable goods compared with manufacturers' inventories, total retail sales, new housing starts, personal income, total consumer installment credit.

To measure these eight elements, FORBES monitors ten series of U.S. government data. The last 14 months' data for each series are presented at right.


360 Services
320
280 Total Index
Consumer price indexes (1967 = 100) all urban consumers, unadjusted (Dept. of Labor)
190
150
110
New housing starts (thousands) privately owned, unadjusted (Dept. of Commerce)
126
124
122
Industrial production index (1967 = 100) seasonally adjusted (Federal Reserve)
180 Inventories
140
100 New orders
Manufacturers' new orders and inventories ($billions) seasonally (Dept. of Commerce)
1,920
1,840
1,760
Personal income ($billions) wage and salary disbursements, seasonally adjusted (Dept. of Commerce)
250
350
450
Unemployment claims average for month (thousands) seasonally adjusted (Dept. of Labor)
113
107
101
Retail store sales ($billions) seasonally adjusted (Dept. of Commerce)
490
460
430
Consumer installment credit ($billions) total, seasonally adjusted (Federal Reserve)
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The IRS has blessed a hybrid called "mandatory convertible notes" for banks. But debt by any other name is still debt.

Lord, make me chaste, but not just yet

By Laura Saunders

UNDER PRESSURE FROM federal regulators to increase their primary capital to 6% of assets or better, commercial banks have been up against the wall lately. With many bank stocks selling below book value because of all those precarious foreign and energy loans in their portfolios, banks face the prospect of selling common stock into an unreceptive market and at low prices.

One solution is an exotic new creature called "mandatory convertible notes." In plain English, that means ordinary long-term borrowings that the banks promise to replace with equity sometime in the next 12 years. Call them equity IOUs.

The big question was whether the Internal Revenue Service would recognize the new hybrid as debt. After all, the rights of noteholders are subordinated to those of general bank creditors. Also, at maturity (or call) the notes can be exchanged for equity, although they are expected to be redeemed for cash. So a great sigh of relief went up from bankers on July 29 when the IRS bestowed its blessing on mandatory converts as a legitimate debt instrument for tax purposes.

Banks scrambling for capital have already floated nearly $10 billion of them since mandatory converts became popular in 1982 *(see table)*. They sorely need the tax deduction that goes with paying interest on debt rather than dividends on equity. For some, the interest cost of these notes runs over $50 million a year. Several recent issues even contained tax-call provisions in case the IRS ruled unfavorably. "If the IRS had decided they were equity, we would have had to do something drastic," says John Stephan, tax counsel at Bank of America, which has $1.2 billion worth of mandatory converts outstanding.

Now comes the really nice news: The notes may be debt to the IRS, but they're equity to the regulators—the Fed, the FDIC and the Comptroller of the Currency. They allow banks to count mandatory converts as primary capital. Up to 20% of a bank's conventional primary capital—usually common and preferred stock—can be in these new hybrid notes. So the banks get to have their cake and eat it, too.

The only thing left unsatisfied is logic: How can something be both debt and equity? How can both the IRS and the regulators be right? Common sense says this is impossible, and common sense is right. The experts agree that the IRS was right in deciding that mandatory converts are debt. They have 11 out of 13 common characteristics of debt, the IRS noted in Revenue Ruling 85-119. "You know the saying," says John Garry, senior vice president at Morgan Guaranty. "If it looks like a duck and sounds like a duck, maybe it is a duck."

But the IRS was careful to limit it to ducks. It approved only a plain vanilla version of mandatory converts. That should restrain eager underwriters from adding equity bells and whistles to lower interest costs by "strengthening" the conversion factor.

The fact that bank regulators permit this debt—which will become equity only far down the road—to count as equity capital shows how worried they are about the financial health of the banks. Says Ernst & Whinney's David Berenson, "Maybe they think that if they can fool more of the people more of the time, there will be more confidence in the banking system."

Kind of reminds us of St. Augustine's famous prayer: "Give me chastity, but not just yet." ■

Equity IOUs

For banks, mandatory convertible notes are like having your cake and eating it, too. The IRS says the interest on them is deductible, but regulators allow banks to count them as primary capital.

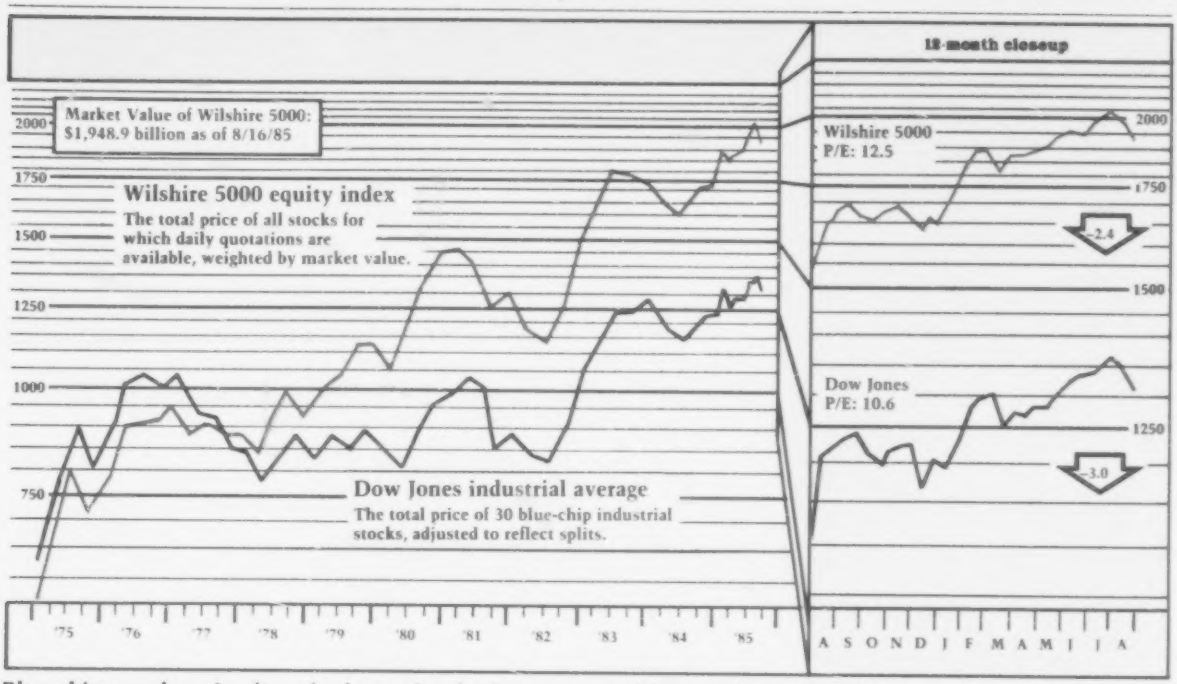
Issuer	Mandatory convertibles outstanding (millions)*	% of primary capital
Citicorp	$1,900	20
BankAmerica Corp	1,200	16
Chase Manhattan Corp	900	16
Security Pacific Corp	500	16
Manufacturers Hanover Corp	440	9
Bankers Trust (NY)	400	13
Wells Fargo & Co	300	15
Marine Midland Banks, Inc	250	16
Mellon Bank Corp	250	12
JP Morgan & Co	250	5

*Entire amount may not count as primary capital for regulatory purposes.

Source: Salomon Brothers, Keefe, Bruyette & Woods.

The Forbes/Wilshire 5000 Review

Edited by Steve Kichen



Blue chips weaken. Leading the losers for the last two weeks was the Dow Jones industrial average, off 3%. Is the market retreating from its alltime highs, or is this a temporary correction? It's a question worth asking, inasmuch as the other major indexes also show declines for the latest two-week and four-week periods. The NYSE and the Nasdaq were both off 2.7% over the past two weeks. The broad-based Wilshire index lost 2.4%. The Amex, meanwhile, has been hit least of all over the two- and four-week periods, off only 1.4% and 2.2%, respectively. In part, that's because domestic energy producers, many of which are traded on the Amex, were one of the sectors with the smallest losses.

The Dow now stands 8.3% higher than it was this time last summer. With dividends, the return on big industrial stocks has been not much better than that on Treasury bills. What's worse, only four weeks ago the Dow stood at 23.4% above year-earlier results.

Closeup On The Equity Markets

Performance of six leading indexes

Percent change	Wilshire 5000	Forbes 500[1]	Dow Jones industrials	NYSE Composite	Amex Market Value Index	NASDAQ Composite
in last 4 weeks	–4.3	–4.1	–3.4	–4.7	–2.2	–3.7
in last 52 weeks	15.3	16.7	8.3	14.3	11.5	18.4

Stock performance based on s. key investor yardsticks

Percent change	Company size		Volatility[2]		P/E multiple		Dividend yield		Growth profile[3]		Share price	
	large	small	high	low	over 25	under 5	over 7.5%	none	high	low	over $40	under $4
in last 4 weeks	–4.4	–0.1	–0.5	–2.4	–2.4	–2.5	–3.4	–0.8	–0.3	–3.3	–3.7	–0.8
in last 52 weeks	19.5	20.2	22.7	32.6	11.8	31.1	28.2	23.6	20.3	28.4	26.7	8.7

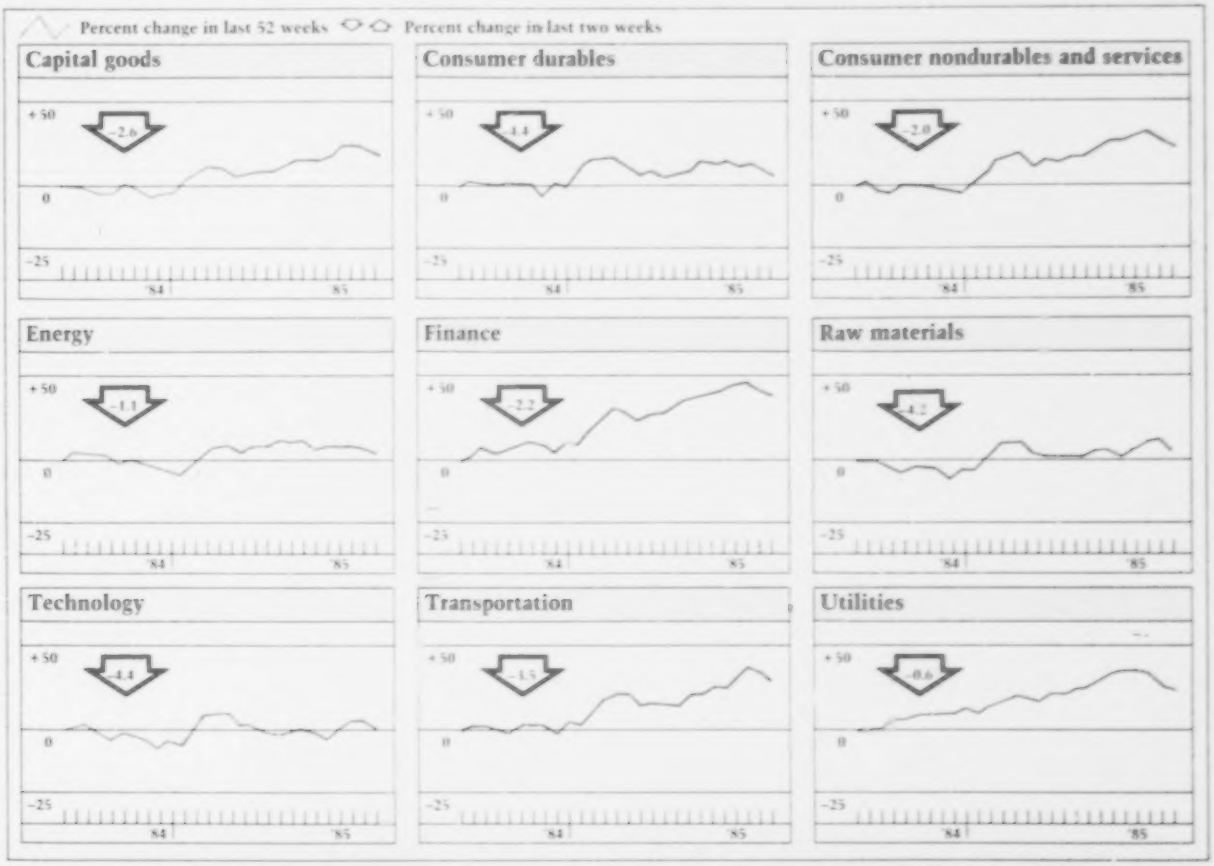
[1]Based on sales.
[2]A stock's sensitivity to overall market movement. High-volatility issues have wide price fluctuations, low-volatility issues are more stable.
[3]A quantitative evaluation of a stock's growth image, determined by Wilshire Associates.

Note: All data for periods ending 8/16/85. Prepared by Wilshire Associates, Santa Monica, Calif.

Where The Action Is

Low bets for high tech. Technology shares, which had managed to eke out gains since the start of July, blew a fuse during the latest two-week period, losing 4.4%. It is the only sector to have lost ground over the past year, off 0.6%. (Dividends are scanty in this sector, too.) While would-be bargain buyers might argue that technology stocks are cheap, the question is, compared to what? Compared to former highs, yes, but not necessarily compared to intrinsic value *(see story, p. 142)*.

Tied with technology for worst place over the last two weeks are consumer durables. Only one big firm, Subaru of America, was up; this has been one of the big holdings in fast-growing Fidelity Magellan Fund. Some of the dogs: Whirlpool and General Motors, each off more than 7%.



What The Analysts Think

No rose-colored glasses here. With second-quarter corporate earnings coming in mostly lower than expected, analysts continue to slash earnings estimates on all sectors except finance and consumer nondurables. The technology and raw materials groups received the heaviest blows over both the two-week and four-week periods.

Forecasting the Forbes 500

Performance period	Average earnings per share	P/E
latest 12 months	$3.47	11.3
1985 estimates	3.94	10.0
1986 estimates	4.52	8.7

Rank based on change in estimate	Sector	Estimated 1985 EPS	Estimated 1985 P/E	% change in 1985 estimate in 2 weeks	% change in 1985 estimate in 4 weeks
1	Finance	$3.19	10.0	0.01%	-0.02 %
2	Consumer nondurables	2.47	12.6	0.00	-0.21
3	Utilities	3.38	7.9	-0.18	-0.32
4	Consumer durables	4.73	7.7	-0.45	-0.43
5	Energy	3.42	8.4	-0.63	-1.12
6	Transportation	2.64	10.3	-0.80	-2.19
7	Capital goods	2.72	11.6	-0.82	-1.91
8	Technology	2.58	12.8	-1.22	-3.00
9	Raw materials	1.96	12.8	-1.54	-3.00

Earnings projections are capitalization-weighted consensus estimates from over 2,000 security analysts. Data are compiled and updated continuously by the Institutional Brokers Estimate System (IBES), a service of Lynch, Jones & Ryan, a New York-based brokerage firm.

Note: All data for periods ending 8/16/85. Prepared by Wilshire Associates, Santa Monica, Calif.; IBES, a service of Lynch, Jones & Ryan, New York.

Now that the threat of a southern hemisphere frost has passed, what can sustain coffee prices at current levels?

HAVE ANOTHER CUP—PLEASE

By Stanley W. Angrist

Like those of many of the world's commodities, coffee prices are in a blue funk. Historically, the main driving force for higher prices during the summer months is the threat of a southern hemisphere freeze that might damage the crop. There were a couple of freeze-scare rumors during June and July that sent the market limit up, but there was little or no follow-through.

The statistics look pretty grim for the bulls. The International Coffee Organization (ICO) strives to maintain prices between $1.20 and $1.40 per pound by means of an export quota system. The system comes into play when an average composite cash price crosses certain trigger prices. And, like all cartels, it works far better on paper than in practice. The chief problems are the same ones that OPEC faces now: cheating and oversupply.

Recently, the 15-day moving average of prices dropped below the $1.30 trigger price and prompted a 1-million-bag (132 pounds per bag) reduction in allowed exports. The problem is that so long as cheating goes on and the ICO is unable to keep in touch with changing market conditions, the fundamentals will ultimately determine the price. And the fundamentals are all saying let the buyer beware.

Estimated world production of coffee in the 1984-85 crop year is 93.5 million bags, while consumption is estimated at 91.1 million bags. (The crop year begins Oct. 1.) The 1984-85 crop is the second largest on record, smaller only than that of 1981-82. Moreover, the 1985-86 crop is likely to be a record-setter. The table shows the supply/demand statistics for recent years and estimates for the coming crop year.

Brazil, the world's largest producer of coffee, accounted for about 28% of the world coffee output in the most recent five years. The Brazilian frost season is the major uncertainty affecting midyear coffee prices. An examination of the frost dates for Brazil shows that the latest frost in the past 35 years occurred in mid-August.

Since the season of adverse weather that could affect the crop has passed, it is no longer a factor. So I believe that the only reasonable position to take is to be a bear. While the quota system will try to limit exports from the producers, it seems to me that once again the inherent limitations of cartels will come into play. At any rate, I would be a seller, looking for lower prices.

I would try to sell the December contract above $1.35 per pound. One contract is for 37,500 pounds, so a 1-cent move is worth $375. I believe that coffee prices could fall another 15 cents per pound, or $5,625 per contract. I would risk no more than 6 cents per pound ($2,250 per contract) from my entry point. The margin on this trade is $1,500, while the round-turn commission is about $25 at a discounter.

A second approach would be to initiate a bear spread by selling short December against a long position in March, with March carrying no more than a 200-point premium to the December. I would risk no more than 200 points on this spread ($750 per spread) and look for a 250-point profit ($937 per spread). The margin is $900 and the round-turn commission is about $50 with a discount broker.

Beware! Historically, coffee has been extremely volatile, partly because the market is thin and partly because of the unreliability of the data affecting the crop. If you take either or both positions, monitor them closely. ■

Stanley W. Angrist is a commodity speculator, consultant and longtime observer of the commodity markets.

Too much caffeine

Once again the amount of coffee on hand is going to rise this crop year, which ends on Sept. 30. The prospects are for another bumper crop next year. The ICO cartel tries to keep coffee supplies in balance with usage but its success has been limited. The numbers given below are in millions of bags at 132 pounds each.

	1982-83	1983-84	1984-85*	1985-86*
Beginning stocks	44.9	43.2	44.8	48.0
Production	83.4	90.4	93.5	99.9
Imports	0.7	0.7	0.7	0.7
Total supply	129.0	134.3	139.0	148.6
Domestic usage	20.9	21.6	21.8	22.5
Exports	64.9	67.8	69.2	70.5
Total usage	85.8	89.4	91.0	93.0
Ending stocks	43.2	44.9	48.0	55.6

*Estimated. *Source: The U.S. Department of Agriculture*